

## >: Which Stocks Should I Buy?

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This is the question at the heart of security analysis. How do analysts choose the stocks and other securities to hold in their portfolios?

Security analysis requires a wide mix of skills. You have to be a decent economist with a good grasp of both macroeconomics and microeconomics, the former to help you form forecasts of the general market direction and the latter to help you assess the relative position of particular industries or firms.

You also need to understand accounting and corporate finance.

In short, a good security analyst will be a generalist, with a grasp of the widest range of financial issues. This is where there is the biggest premium of putting it all together.

### TOP DOWN APPROACH TO INVESTING!

#### THE ECONOMY:

##### 1. Go Global

How is the global economy doing? Everything is so interconnected now. What happens in a faraway land affects us here in the U.S.A. and vice versa. How is our exchange rate? The exchange rate is the rate at which domestic currency can be converted into foreign currency. For example, the U.S. dollar has fallen, lost value relative to other currencies. This will make our goods more attractive to foreigners because they are less expensive to them in terms of their currency. This is good for U.S. companies who export goods. It will increase their revenue, and their stock price should follow.

##### 2. The Domestic Macroeconomy

How is the U.S. economy doing? At the very least, look at the prime economic indicators for those of you who are super busy.

###### A) GDP (Gross Domestic Product) =

The market value of goods and services produced over a period of time. Rapidly growing GDP indicates an expanding economy with ample opportunity for a firm to increase sales.

**B) Unemployment Rate** The ratio of the number of people classified as unemployed to the total labor force. Guess what, folks? When more people are working, more people are spending. When people spend, this is good for corporate profits and, ultimately, stock prices.

**C) Inflation** The rate at which the general level of prices for goods and services is rising. High inflation rates are often associated with 'overheated' economies, that is, economies where the demand for goods and services is outstripping productive capacity, which leads to upward pressure on prices.

Remember when your grandfather used to tell you how a dollar is not what it used to be anymore? He was basically talking about inflation. When a dollar used to get you a lot more than it gets you today.

**D) Interest Rates** The cost of money. Higher interest rates are not good for stock prices because they reduce the present value of future cash flows. For example, the present value of a \$1,000 loan discounted at 5% ( $1000/1.05$ ) is about \$952. Let's say interest rates go up to 9%. Then the present value is only \$917.

**E) Budget Deficit** The amount by which government spending exceeds government revenues. Remember, folks, that any budgetary shortfall must be offset by government borrowing (e.g. China). Large amounts of government borrowing can force interest rates up by increasing the total demand for credit in the economy. Economists generally believe excessive government borrowing will 'crowd out' private borrowing and investing by forcing interest rates up and choking off business investment.

**F) Sentiment** Consumers' and producers' optimism or pessimism concerning the economy are important determinants of economic performance. Happy consumers usually spend more money.

#### INDUSTRY:

After having studied the economy, we could narrow our focus even further by looking at which industry looks good to us.

I will defer to one of the legends on this subject, Michael Porter, who, in his book, *Competitive Strategy*, famously examined the relationships among industry structure, competitive strategy, and profitability. This will help you narrow down an industry

that looks good, and from there, you can find one of the best companies (stocks) in that industry to own.

### **Michael Porter's Five Determinants of Competition:**

#### **1. Threat of Entry**

New Entrants to an industry put pressure on price and profits. Even if a firm has not yet entered an industry, the potential for it to do so places pressure on prices, since high prices and profit margins will encourage entry by new competitors. Therefore, barriers to entry can be a key determinant of industry profitability.

#### **2. Rivalry among existing competitors**

When there are several competitors in an industry, there will generally be more price competition and lower profit margins as competitors seek to expand their share of the market. Slow industry growth contributes to this competition since expansion must come at the expense of a rival's market share. High fixed costs also create pressure to reduce prices since fixed costs put greater pressure on firms to operate near full capacity. Industries producing relatively homogeneous goods are also subject to considerable price pressure since firms cannot compete on the basis of product differentiation.

#### **3. Pressure from substitute products**

Substitute products mean that the industry faces competition from firms in related industries. As an example, sugar producers compete with corn syrup producers. Wool producers compete with synthetic fiber producers. The availability of substitutes limits the prices that can be charged to customers.

#### **4. Bargaining power of buyers**

If a buyer purchases a large fraction of an industry's output, it will have considerable bargaining power and can demand price concessions. For example, auto producers can put pressure on suppliers of auto parts. This reduces the profitability of the auto parts industry.

#### **5. Bargaining power of suppliers**

If a supplier of a key input has monopolistic control over the product, it can demand higher prices for the good and squeeze profits out of the industry. The key factor in determining the bargaining power of suppliers is the availability of substitute products. If substitutes are available, the supplier has little clout and cannot extract higher prices.

Folks, this was just a top down primer on how to begin to narrow your focus to find the right stock to invest in. As you can see, it is not as easy as some others make it out to be. If it were, then everyone would be a millionaire. It takes hard work and dedication to find a stock that will make you money and, more importantly, that will not lose you money. We will delve deeper next week. Stay tuned.

Oh, by the way, the next time someone asks you, "Which stock(s) should I buy?? you may want to get comfortable, because it's going to take you a long time to explain it to them ...

**Until the next time, folks, spend your hard-earned money wisely.**



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